CRC MEMORANDUM

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MICHIGAN'S FISCAL FUTURE

For seven years, Michigan has endured its worst financial crisis in more than 50 years. Cyclical and structural pressures have combined to produce both deteriorating revenue performance and escalating spending pressures. Although the State has successfully balanced budgets in each fiscal year, this has been accomplished by the use of reserves and through actions designed to minimize spending cuts. The fundamental issue of matching available on-going revenues with spending remains only partly addressed.

The task facing policy makers over the next several years will be to bring the growth of spending pressures in both the General Fund and the School Aid Fund into line with the growth of revenues. The projected gaps are significant. If current spending and taxing policies are unchanged, a gap of $6 billion will develop by Fiscal Year 2017 in the General Fund and $3.6 billion in the School Aid Fund. The Michigan Constitution prohibits budget deficits, so these gaps will not materialize. But, these projections provide an indication of the magnitude of policy changes that will be necessary in order to restore long-term balance to the State budget.

Budget deficits can be classified as either *cyclical* or *structural* to reflect their causes. *Cyclical* deficits are caused by a decline in the economy. Revenue performance worsens and some spending pressures increase, creating gaps between the cost of maintaining programs and the resources available to pay for them. Unlike a business, which is adversely affected by a recession through lost customers and declining sales, the customers for state and local government programs expect the services to continue, even with declining revenues. Programs such as K-12 education expect essentially the same levels of enrollment, whether revenues are increasing or declining. Other programs sensitive to unemployment levels may experience an increase in the number of citizens requesting assistance at the same time governmental revenues are decreasing. When the economy improves, cyclical deficits tend to be self-correcting.

Structural deficits are created when the costs of maintaining programs and policies increase faster than revenues even when the economy is performing well. Structural deficit pressures may also exist when the economy is doing poorly and, combined with cyclical pressures make balancing the budget even more difficult.

Economic Review and Short Term Outlook

The Michigan economy and state and local government programs and finance have been under significant stress since Fiscal Year 2001 (FY01). State government revenue performance paralleled the economic decline. Aggressive cuts in Personal Income Tax and Single Business Tax rates, enacted in the good times of the late-1990s, exacerbated the dismal performance of the tax base. Revenue performance has failed to keep pace with spending pressures associated with continuing programs and policies on a year-to-year basis. From FY00 through FY07:

- General Fund revenues dropped by $1.5 billion (15.4 percent)
- Income Tax revenues to the General Fund declined by $802 million (15.6 percent)
- Single Business Tax revenues to the General Fund fell by $507 million (21.6 percent)
- State-raised School Aid Fund revenue grew $829 million (8.0 percent), an annual rate of only 1.1 percent.

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Michigan's Fiscal Future was prepared by the Citizens Research Council of Michigan and the W. E. Upjohn Institute for Employment Research. Both organizations recognized the need to assess to future dynamics of the interaction of the Michigan economy with the governmental programs supported by the tax revenues dependent on the performance of that economy. This CRC Memorandum is a summary of CRC Report No. 349 (available on CRC website).

The report was generously supported by the Herbert H. and Grace A. Dow Foundation, the Frey Foundation, the W. K. Kellogg Foundation, and Detroit Renaissance.

- Sales Tax revenues, the largest School Aid Fund revenue source, increased by only 4.2 percent.

Because the deterioration in the economy and revenue performance began occurring as the FY01 budget was being completed, spending in FY01 was supported by nearly $1.2 billion in one-time resources and no significant cuts in spending were made. Significant changes occurred in subsequent years, however:

- General Fund spending dropped by $673 million (6.5 percent)
- Higher education spending dropped by $184 million (8.8 percent)
- Department of Human Services lost $56 million in General Fund support (4.5 percent)
- Statutory revenue sharing for cities, villages, townships, and counties was cut by $558 million (58.3 percent)
- School Aid spending from state-raised revenues increased by $529 million (4.9 percent or 0.8 percent per year). K-12 program reductions were required to accommodate increases for school personnel retirement, health insurance, and salaries.
- State government work force dropped by 9,500 employees (15.2 percent), bringing the number of State employees below the level of FY74
- Corrections spending increased by $253 million (15.8 percent)
- General Fund Community Health spending (largely Medicaid and public and mental health programs) increased by $251 million (9.3 percent)

The financial condition of the State has deteriorated to the point that reserves are exhausted and cash-flow problems threaten the ability to make payments on a timely basis.

Economic Projections

The budgetary projections in this report are based on a series of assumptions about the performance of the Michigan economy from 2007 to 2017. Projections of State spending are based upon a moderately growing state economy, an improvement over the experience of the last seven years.

The Michigan economy will be driven by the national economy, which is projected to experience the following rates of change:

- Real Gross Domestic Product up by 2.7 percent per year
- Employment up by 0.9 percent per year (slightly below population growth of 1.0 percent per year)
- Manufacturing employment down by 1.3 percent per year (2.8 percent decline in auto employment)

Employment growth will be concentrated in the service sector, specifically, health care, business administrative, leisure and hospitality, and educational services.

Rates of change for Michigan include:

- Personal income up by 4.2 percent per year (real disposal personal income, 2.3 percent)
- Share of U. S. personal income down by 9 percent from 3.3 percent to 3.0 percent
- Employment basically unchanged, with declines in manufacturing (3.5 percent per year) and increases in health care (2.4 percent per year) and leisure and hospitality (0.5 percent per year)

Population Projections

The Michigan demographic landscape will undergo a marked transformation during the period of the projections. While total population will remain unchanged, its composition will change:

- The over-65 cohort increases 2.8 percent per year; other cohorts decline
- School age (5-17) population declines by 1.5 percent per year

- The decline in Michigan's share of the U. S. population will accelerate from 0.7 percent per year (1997-2007) to 1.1 percent per year (2007-17), dropping the share from 3.3 percent to 3.0 percent

Michigan Revenue Structure and Projections

This report covers budgets supported by three major state funds: General Fund (GF), School Aid Fund (SAF), and Transportation Fund. Each of these funds depends heavily on state taxes for its revenues and is reliant upon the Michigan economy to produce the activity to generate the tax revenues. The connection between the Michigan economy and the state tax structure has weakened since the late-1990s leading to a lag between the growth of the economy and growth in tax revenues.

Major changes in the tax structure made during FY07 will affect the revenues for FY08 and beyond. Substitution of the Michigan Business Tax (MBT), a tax on business income and gross receipts, for the Single Business Tax (SBT) in 2007 is projected to result in essentially no change in revenue. Also in 2007, the rate of the Personal Income Tax was increased by 0.45 percentage points, from 3.9 percent to 4.35 percent. That increase, plus a surcharge on the MBT, are projected to yield approximately $1.2 billion in FY08 (partial year) and $1.5 billion in FY09.

Six major taxes (Personal Income, Sales, Use, MBT, State Education, and Tobacco Products) provide the bulk of the revenues to the GF and SAF and the projections in this report focus on those taxes. The overall growth paths of the revenues to the GF and SAF are the same (3.0 percent), before adjustments for future changes already in law are factored in. Two series of tax cuts are in state law for FY09 and beyond (Earned Income Tax Credit and phase-out of the 2007 Personal Income Tax increase) and will have the effect of reducing the already anemic annual growth rates in GF revenues to less than 1.0 percent in several years beyond FY10. Overall, the cuts reduce the average annual growth rate from 3.0 percent to 1.4 percent, with GF revenues rising from $10.0 billion in FY09 to $11.1 billion in FY17. Funds available to finance K-12 education (state, federal, local) are projected to grow from $18.1 billion to $23.0 billion in that period (3.0 percent annually).

Michigan Budget and Spending Pressure Projections

General Fund spending pressures are projected to grow from $10.1 billion in FY09 to $17.1 billion in FY17, an annual rate of growth of 6.8 percent. This growth is not uniform across GF programs, nor is it consistent each year during the projection period. Average annual growth rates range from 10.7 percent for Medicaid to 4.1 percent for most general government programs. School aid spending pressures are projected to grow from $18.4 billion in FY09 to $26.6 billion in FY17, or an annualized rate of 4.7 percent.

Medicaid and corrections are the main drivers of GF spending pressure growth, while health care coverage for both active and retired employees is the principal factor in the growth of K-12 spending pressures.

Employee Compensation

Employee compensation expenditures by the State and, especially, by K-12 school districts will continue to contribute to the structural deficit. Spending on salaries and fringe benefits represents nearly 80 percent of total annual K-12 spending, whereas compensation accounts for only about 11 percent of total State spending. The growth in compensation spending pressures will be driven heavily by health care benefits provided to both current and retired employees.

With respect to GF compensation:

- Spending pressures are projected to rise 4.8 percent annually from nearly $2.9 billion in FY09 to over $4.3 billion in FY17.
- Nearly one of every three dollars (31 percent) in FY17 will be spent on health care for current and retired employees; up from 22 percent in FY09
- Total compensation spending pressures will increase by an average of $159 million per year

With respect to K-12 compensation:

- Spending pressures are projected to rise 5.1 percent annually from $14.4 billion in FY09 to $21.4 billion in FY 17
- Total compensation spending pressures will increase by an average of $875 million per year, or $700 per pupil per year
- Declining enrollments will lead to teacher attrition and help to moderate overall salary spending growth; however, health care spending pressures will continue to grow

K-12 School Aid

In FY07, Michigan public elementary and secondary schools provided education to 1.7 million pupils through 552 school districts, 229 public school academies, and 57 intermediate school districts operating in about 4,000 facilities.

State aid to K-12 schools is supported by the School Aid Fund (SAF), which is composed primarily of revenues from the Sales Tax, Use Tax, State Education Property Tax, the State Lottery, Casino Gaming Tax, liquor and tobacco taxes, and the Real Estate Transfer Tax. These sources are supplemented at the local level by local property taxes levied largely on business property.

Consonant with the decline in school age population, K-12 enrollment is projected to decline from 1.65 million in FY08 to 1.45 million in FY17, an average annual decline of 1.4 percent. Spending pressures do not, however, decline in concert with enrollment declines because pupil loss is typically spread out in a way that hinders concurrent reduction in expenditures.

K-12 revenues are projected to grow at a rate of 3.0 percent per year from $17.7 billion in FY08 to $23.0 billion in FY17, while spending pressures are projected to grow at a rate of 4.7 percent per year from $17.7 billion in FY08 to $26.6 billion in FY17, creating a gap of $3.6 billion.

The gap is largely attributable to spending pressures for health care both for current employees, which is projected to grow at an annual rate of 9.3 percent, and for retired employees, which is projected to grow at an annual rate of 11.9 percent.

Table 1
Projected Growth in K-12 Spending Pressures, FY09 to FY17

Spending Pressures	Annual Rate of Change, FY09-FY17
Payroll	3.3%
Pension Benefits	3.3%
Retiree Health Care	11.9%
Other Benefits (Employee Health Care)	9.3%
Other Spending	3.3%
Total	4.7%

Source: CRC calculations.

Higher Education

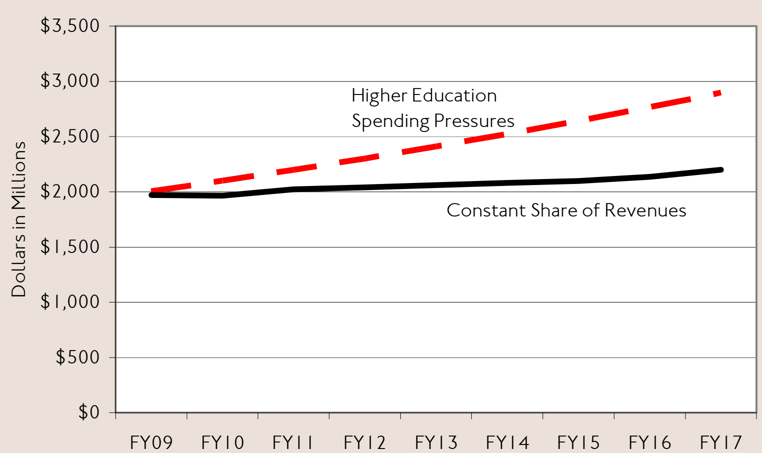
State appropriations support the operations of 15 state universities and 28 community colleges in Michigan. In FY07, General Fund support was $1,625 million for universities and $290 million for community colleges.

Reduced support for higher education has been a key part of the State response to declining GF revenues. From FY00 to FY07:

- State appropriations to state universities declined by 0.6 percent per year, while tuition and fees grew by 9.4 percent annually.
- State appropriations to community colleges declined 0.5 percent per year, while tuition and fees grew by 9.2 percent and local property tax support grew by 7.3 percent per year.

Despite, or perhaps owing to, declining economic conditions in

Chart 1
Projected Higher Education Spending Pressures and Revenue Growth, FY09 to FY17



Michigan, enrollments increased significantly from FY00 to FY07 and are projected to continue to increase (by 1.2 percent per year), even though the college age population is projected to decline.

While GF revenues are projected to rise by 1.4 percent per year, higher education spending pressures are projected to grow by 4.7 percent per year. Even if higher education maintains its current share of GF revenues (19.8 percent), a gap of approximately $700 million would open up by FY 17.

Medicaid and Related Health Programs

Medicaid is a state-federal health insurance program for low-income recipients. Nationally, Medicaid accounts for about one-sixth of health care spending and nearly half of all spending on long-term care. MIChild is the Michigan version of the state-federal State Children's Health Insurance Program (SCHIP). Michigan also has responsibility for 90 percent of the funding of Medicaid Part D drug program for Medicaid recipients. Medicaid, MIChild , and the state obligation for Medicare Part D prescription drugs total $10.4 billion from all sources and absorb $2.4 billion, or 25.6 percent of FY08 GF appropriations.

Medicaid services are either mandatory or optional and Michigan has expanded both the services covered and the categories of low income families and individuals eligible for the services beyond federal minimum requirements. Optional services, however, include pharmaceuticals, emergency care, and nursing home care, services not easily eliminated.

Medicaid and related health programs have been, and will continue to be the most rapidly growing portion of both GF and total State spending. The projected annual growth rate of these programs (GF portion) is 10.1 percent through FY 17, far greater than the projected GF revenue growth rate of 1.4 percent. Total spending pressures are projected to rise from $10,417 million in FY08 to $20,227 million in FY 17, with the GF portion rising from $2,412 million to $5,732 million during that period.

Mental Health

Since the mid-1960s, the delivery of mental health services to Michigan residents has shifted from state-run hospitals to the community level. The advent of psychotropic drugs and changes in state law aided this transition and resulted in the closure of 26 state inpatient facilities since 1978. Despite this marked change in the mode of service delivery, the State budget still plays a major role in financing behavioral health care services. In FY08, the State will support $2 billion in mental health services for Medicaid and non-Medicaid eligible individuals. From FY09 to FY 17:

- Total mental health spending pressures will double to over $4 billion
- General Fund spending pressures for Medicaid mental health services will increase by 8.6 percent per year, nearly six times faster than the projected GF annual revenue growth rate
- Non-Medicaid GF mental health spending pressures will increase by 2.9 percent per year (approximately twice as fast as projected GF revenues), rising from $449 million in FY09 to $564 million in FY 17
- The rising cost and use of prescription drugs, together with caseload increases, and the aging Michigan population, will contribute to mental health spending demands during the projection period.

Human Services

Human services programs, including income support, day care, foster care, adoption, and family preservation, have undergone major transformations since the passage of federal welfare reforms in the mid-1990s. Spending on traditional public assistance programs has been replaced by spending on services designed to assist individuals in securing employment. The Michigan Family Independence Program (FIP) caseload reached a low in FY01 before beginning a rise through FY07.

Future human services spending pressures will be determined by economic factors as well as by state policies, including state employee compensation. State economic performance will influence the number of individuals served by human services programs, while state policies will determine benefit levels, eligibility criteria, and benefit time limits.

Whereas FIP caseloads have slowly increased since FY01, benefit levels have remained virtually untouched for almost 20 years. Despite infrequent benefit increases, the projection of spending pressures includes an annual inflationary increase in benefit levels in order to maintain the current purchasing power of grants.

Overall, human services GF spending pressures are projected to increase by 3.2 percent per year from $1.3 billion in FY09 to slightly more than $1.7 billion in FY 17. Michigan's share of federal Temporary Assistance to Needy Families is fixed at $775 million per year, meaning that any increase in the spending pressures resulting from caseloads or benefits will have to be supported by state resources alone.

Corrections

Corrections constitutes the largest program operated directly by state employees, has grown by an annual rate of nearly 4 percent since FY00, and will be second only to health care as a contributor to the State General Fund structural deficit through FY 17. The Department of Corrections now employs over 16,000 persons, nearly one-third of the classified State workforce.

Growth in Corrections spending will be fueled by a projected 2.2 percent annual growth rate in the number of prisoners, or nearly 1,300 per year. While Michigan does not sentence an extraordinarily large number of felons compared to other Great Lakes states, the average length of stay is nearly 60 percent longer, resulting in substantially higher incarceration rates (489/100,000 population vs. 338/100,000 in 2006). Under present policies, the Michigan incarceration rate is projected to rise to 623/100,000 by FY 17.

Highway Finance

Although not funded by the General Fund and therefore not part of the gap between GF spending and revenues, highway construction is a large part of the total State budget and is subject to many of the same forces that condition other State programs.

Michigan highway revenue sources (Motor Fuel and Vehicle Registration taxes) have failed to fund the planned construction and maintenance of the State highway system, resulting in unmet system condition goals. Moreover, the current funding structure will not result in revenue growth sufficient to keep pace with the projected spending pressures facing the system.

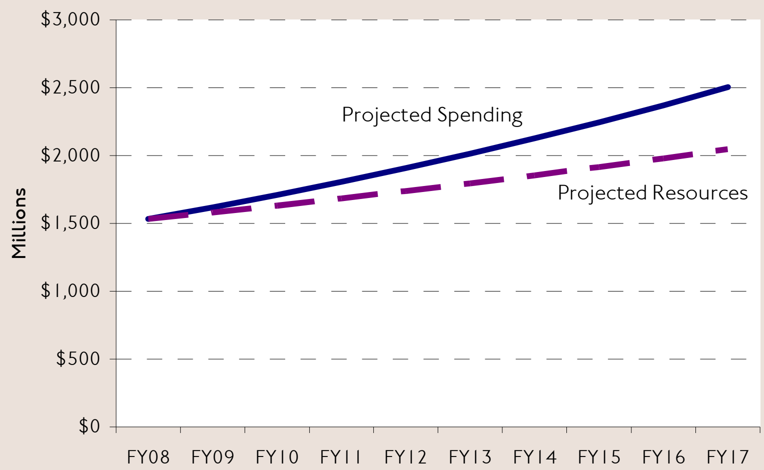
The Gasoline Tax was last increased in 1997 ($0.04/gallon). However, slow growth in motor

Table 2
Corrections Projections, FY08 to FY 17

Fiscal Year	Prisoners	Incarceration Rate	Total Spending (millions)	Spending per Capita	Facility Debt Service (millions)
2007-actual	50,203	497.4	$1,866.4	$185	
2008-estimate	51,394	509.7	1,996.1	198	
2009	52,100	517.2	2,118.5	211	$2.1
2010	53,598	532.5	2,250.9	224	8.5
2011	55,124	548.3	2,415.7	240	10.9
2012	56,094	558.6	2,593.8	258	13.8
2013	57,335	571.2	2,786.3	278	17.4
2014	58,603	584.0	2,994.4	298	21.1
2015	59,899	596.8	3,219.4	321	24.8
2016	61,224	609.6	3,462.8	345	20.8
2017	62,578	622.5	3,726.2	371	41.2
Average Annual Increase FY09 to FY 17	2.3%	2.3%	7.3%	7.3%	

* 2008 to 2012 figures from Michigan Department of Corrections Prison Population Projection Report, January 2008; 2013 to 2017 figures based on CRC projections.

Chart 2
MDOT Road and Bridge Program Projected State and Federal Resources and Spending, FY08 to FY17



Sources: MDOT; U.S. Department of Labor; CRC calculations.

fuel consumption coupled with the effects of inflation has eroded the purchasing power of the increase. While another increase in the tax rate would provide additional revenue in the short-run, it would do nothing to affect the underlying growth path of this revenue source. Vehicle Registration taxes have accounted for nearly all the annual growth in state highway funding in the past and will continue to do so. Highway revenues (state and federal) are projected to grow at an annual rate of 3.5 percent between FY09 and FY17 with state revenues growing at only 2 percent. State revenue for state roads and bridges (not including revenues directed to local units) is projected to grow from $776 million in FY08 to $928 million in FY17.

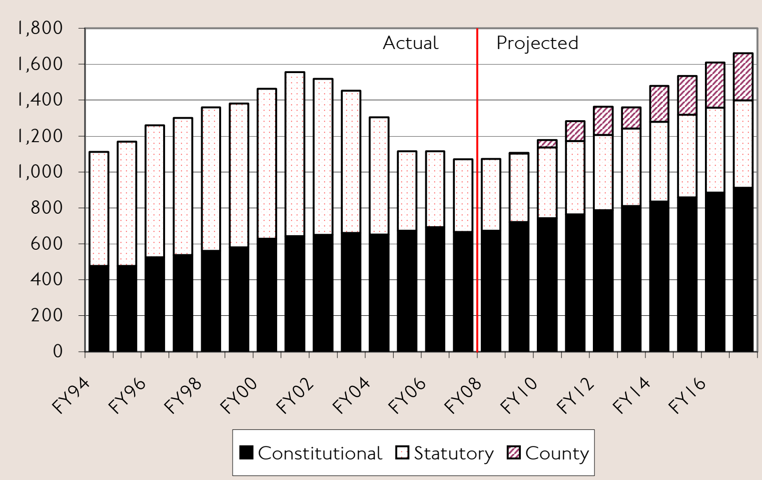
Projected spending pressures will increase by 5.6 percent per year, not including costs associated with unmet needs prior to the projection period. Adding those costs would dramatically increase the projected spread between spending and revenues. The gap between spending pressures and projected state-federal revenues will be approximately $412 million by FY17.

Unrestricted State Revenue Sharing for Local Governments

The Michigan state revenue sharing program distributes Sales Tax revenues in two ways: The first carries out a constitutional provision to distribute 15 percent of revenues from the Sales Tax collected at the 4 percent rate to cities, villages, and townships on a per capita basis. In addition, a statutory program distributes another 21.3 percent of the Sales Tax revenues to cities, villages, townships (16 percent) and counties (5.3 percent). A 1998 law created a formula that weights the population of cities, villages, and townships by measures of need and tax capacity for distributing these funds. Counties are funded on a per capita basis.

Efforts to deal with the State structural deficit led State policy makers to retain funds that would have been allocated to statutory state revenue sharing in order to make funds available for other programs.

Chart 3
Spending Pressures for Statutory State Revenue Sharing: FY 94 to FY07 Actual and FY08 to FY17 Projected



From FY02 to FY08, over $2.1 billion has been retained in the General Fund. Revenue sharing payments to counties were paused completely in 2004, offset temporarily by the extra funds collected through a shift in the collection of county taxes from winter to summer.

Funds distributed through the constitutional per capita formula are projected to grow at an annual rate of 3 percent—equal to the projected growth rate of the Sales Tax. It is assumed that all cuts in statutory revenue sharing for cities, villages, and townships will continue. It is further assumed that no further cuts will occur for cities, villages, or townships and that counties will recoup their lost payments, with inflationary adjustments. Starting in FY 10, the State will have to make a decision regarding the source of funds to finance revenue sharing for counties, which will amount to more than $100 million in FY 11 and over $200 million by FY 15.

Summary of Structural Deficit Projections

When the projections of spending pressures and revenues are combined, an increasing gap appears. Spending pressures in two areas stand out as major causes of the structural deficit: corrections and health care. Both areas are projected to grow at more than twice the rate of increase in revenues unless policies are implemented that substantially reduce the rates of growth in the two areas. Major tax revenues are not growing as fast as the economy and the share of the overall economy claimed by State taxes will continue to fall. The largest tax sources (Personal Income and Sales and Use) are projected to increase about 3 percent per year.

Spending pressures in public K-12 education are projected to grow about 4.7 percent annually, while revenues are projected to grow at 3.0 percent per year. The gap of about 1.7 percentage points amounts to an annual shortfall of about $300 million.

In the General Fund, revenue growth averages 1.4 percent per year—lower than the School Aid Fund growth rate because of tax cuts already in State law that will pare the growth from a baseline rate of 3.0 percent. GF spending pressures are projected to grow 6.8 percent annually, leaving an average shortfall of 5.4 percentage points, or more than $500 million annually.

The Challenge Ahead

The Michigan Constitution mandates a balanced budget. The State has accomplished this task each fiscal year during the current period of weak economic performance, usually with the use of non-recurring financial resources. It has, however, seen its reserves depleted to the point at which it can no longer avoid the difficult process of bringing its recurring revenues and its spending commitments into long-term balance.

The State budget process contains nothing that forces consideration of the long-term consequences of current policies. As a consequence, policies are often adopted, which, although affordable at the time of adoption, may contain elements of growth that result in budgetary pressure in subsequent fiscal periods. This report is aimed at assisting policy makers in developing strategies that address the structural deficit that continues to plague the Michigan State budget.

Table 3
Summary Calculations of the Structural Deficits, FY09-FY 17

Spending Area	Average Annual Revenue Growth	Average Annual Spending Pressure Growth	Annual Gap (Revenues Minus Spending Pressures)	Annual Structural Deficit in Millions of FY09 Dollars
GF-GP	1.4%	6.8%	-5.4%	$539
School Aid	3.0%	4.7%	-1.7%	$308
Transportation	3.5%	5.6%	-2.1%	$33